

**IT 00-13**

**Tax Type: Income Tax**

**Issue: Unreported/Underreported Receipts (Non-Fraudulent)  
Unreported/Underreported Income (Fraud Application)**

**DEPARTMENT OF REVENUE  
STATE OF ILLINOIS  
OFFICE OF ADMINISTRATIVE HEARINGS  
CHICAGO, ILLINOIS**

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**DEPARTMENT OF REVENUE  
STATE OF ILLINOIS**

v.

**JOHN DOE'S PASTA, INC.**

) 99 ST 00  
) 99 IT 0  
)  
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) NTL SF-  
) TYE: 12/31/95; 96  
)  
) Mimi Brin  
) Administrative Law Judge

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**RECOMMENDATION FOR DISPOSITION**

**Appearances:** Michael H. Moirano of Nisen & Elliott, for JOHN DOE'S Pasta; John Alshuler, Special Assistant Attorney General, for the Illinois Department of Revenue

**Synopsis:**

This matter comes on for hearing pursuant to the taxpayer's, JOHN DOE'S Pasta, Inc. (hereinafter referred to as "Taxpayer" or "JOHN DOE'S") protest of Notice of Tax Liability No. XXXXX (hereinafter referred to as the "NTL") for the tax period of 1/1/95 through 6/30/97, as well as Notice of Deficiency dated September 27, 1999 for the tax years ending 12/31/95 and 12/31/96 (hereinafter referred to as the "NOD"). The issues at hearing are whether the Department's assessment of underreported receipts pursuant to its correction of taxpayer's monthly Retailers' Occupation Tax returns (hereinafter referred to as "ROT") is correct, and, if so, whether the income tax deficiency proposed

on the NOD that reflects these underreported receipts, is also correct. Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department. In support thereof, I make the following findings of fact and conclusions of law:

**Findings of Fact:**

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Audit Correction and/or Determination of Tax Due assessing Retailers' Occupation Tax for the tax period of 1/1/95 through 6/30/97 (hereinafter referred to as the "NTL tax period") as well as late payment and negligence penalties and statutory interest, and the Notice of Deficiency for the tax years ending 12/31/95 and 12/31/96 (hereinafter referred to as the "NOD tax period") proposing income tax due. Department Exs. No. 1, 2
2. Taxpayer was, during the tax periods, a retailer of food. Taxpayer Exs. No. 6-11; Tr. pp. 24-25
3. Taxpayer's books and records were incomplete for the tax periods at issue. Department Ex. No. 4, pp. 2, 3; Tr. pp. 31-32
4. JIM DOE, a certified public accountant (hereinafter referred to as "JIM DOE") prepared taxpayer's federal and Illinois income tax returns for the tax years ending 12/95, 96 and 97. Tr. pp. 13, 18-19, 21-22 He did not prepare taxpayer's monthly ROT returns for the NTL tax period at issue. Tr. pp. 18-19

5. JANE DOE, JOHN DOE'S owner (hereinafter referred to as "JANE DOE") prepared and filed taxpayer's monthly ROT returns. Tr. pp. 18, 19, 33, 34, 37
6. Taxpayer concedes that it underreported its gross sales on its ROT returns for the NTL tax period. Tr. pp. 7, 20, 41, 42
7. During the tax periods at issue, the store had a cash register that generated tapes that were used by JANE DOE to complete the monthly ROT returns, however, none of them were kept by taxpayer. Tr. pp. 31-32, 34

**Conclusions of Law:**

The Department's NTL is based, *inter alia*,<sup>1</sup> upon its determination, following audit, of underreported receipts based upon a mark-up of the equivalent of three times the cost of goods sold. Department Ex. No. 4, p.1; Tr. pp. 22-23 Taxpayer admits that additional tax is due (Tr. pp. 7, 20, 41, 42), however argues that the ROT amount due is the difference between taxpayer's federal filings and its Retailers' Occupation Tax returns filed for the same period, and not the amount assessed by the Department. Taxpayer Ex. No. 5; Tr. pp. 20-22 It also professes that since its Illinois income tax returns for the NOD tax period reflect its federal returns for that time, its Illinois income tax returns correctly reflect its business activity, and therefore, contrary to the NOD, there is no additional income tax owing to the State. Tr. p. 22 In support of its position that the taxpayer's correct ROT liability is as reflected on its federal income tax returns, the taxpayer presented a number of documents, including financial statements for the years

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<sup>1</sup> The auditor also disallowed deductions taken by the taxpayer on its pertinent ROT returns for alleged sales to exempt organizations and sales for resale based upon the lack of supporting books and records. Correction and/or Determination of Tax Due (Department Ex. No. 1); Department Ex. No. 4, p. 3 This part

ending December 31, 1996 (Taxpayer Ex. No. 3) and December 31, 1995 (Taxpayer Ex. No. 4); a schedule entitled “Sales Tax Proposed Settlement” (Taxpayer Ex. No. 5) and a lengthy exhibit wherein various menu items are analyzed for costing purposes (Taxpayer Exs. No. 6, 7 (menu)).

There are well-settled principles of tax law which impact on my determination in this matter. The Department’s *prima facie* case against JOHN DOE’S for ROT liability is established by the admission into evidence of the correction and/or determination of tax due (Department Ex. No. 1) and for income tax, by the Notice of Deficiency (Department Ex. No. 2). A.R. Barnes and Co. v. Department of Revenue, 173 Ill. App.3d 826 (1<sup>st</sup> Dist. 1988); Balla v. Department of Revenue, 96 Ill. App.3d 293 (1<sup>st</sup> Dist. 1981); Rentra Liquor Dealers, Inc. v. Department of Revenue, 9 Ill. App.3d 1063, (1<sup>st</sup> Dist. 1973) Following the admission into evidence of the Department’s *prima facie* case, the burden shifts to the taxpayer to produce competent evidence, identified with its books and records and “supported by proof of facts entitling it to be admitted as evidence or facts from some other source importing equal verity”, showing that the Department’s returns are not correct. DuPage Liquor Store v. McKibbin, 383 Ill. 276, 279 (1943); Copilevitz v. Department of Revenue, 41 Ill.2d 154 (1968) Should the taxpayer overcome the presumptive correctness of the Department’s corrections, the burden is the Department’s to prove its case by competent evidence. Young v. Hulman, 39 Ill.2d 219 (1968)

The threshold issue herein is whether the taxpayer’s evidence rebuts the *prima facie* correctness of the Department’s corrections. I conclude it does not.

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of the audit was not addressed by the taxpayer, therefore, under any circumstance, I recommend that the Department’s disallowance of deductions taken for these sales be affirmed.

Taxpayer's argument at hearing consists of both oral and documentary evidence. JANE DOE testified that she prepared and filed taxpayer's monthly ROT returns using "the sales receipts of the register, and at the end of the month I would take all of these and just follow the procedure on the tax thing. It's not very hard." Tr. pp. 34, 37 She also testified that she attempted to accurately prepare and report taxpayer's sales on those returns. Tr. p. 37 Taxpayer not only failed to retain these very sales records from which JANE DOE ascertained taxpayer's monthly tax liability to the state, but now concedes that these returns are incorrect.

Taxpayer's accountant, JIM DOE, was the other witness for the taxpayer. JANE DOE, who is the owner of the business (Tr. p. 33), is his aunt (Tr. p. 14), who bought this business from another nephew, RON DOE (Tr. pp 33-34). It is through JIM DOE's testimony that most of taxpayer's exhibits were offered and admitted into evidence, without objection from the Department, and, it is JIM DOE who urges that taxpayer's true tax liability is reflected by its sales and costs as set forth in its federal returns. However, taxpayer's argument in this regard is flawed.

Taxpayer avers that its sales mark-up for the tax period is actually 2.2 times the cost of food and beverage rather than the mark-up of 3 as determined by the Department. To support this argument, JIM DOE, who prepared taxpayer's "Financial Statements as of 1995" (Taxpayer Ex. No. 4) and "Financial Statements as of 1996" (Taxpayer Ex. No. 3) testified that taxpayer's 2.2 times mark-up results from dividing taxpayer's total sales by the cost of food and beverage as these are set forth on the federal returns. Tr. pp. 16-18 Although the accountant's math is correct, the flaw in the argument lies with the figures used.

As JIM DOE testified, he calculated taxpayer's total sales using the monthly bank deposits (Tr. p. 17), assuming that the deposits equaled the gross receipts. Tr. p. 30 JIM DOE's only knowledge of the bank deposits is from the monthly bank statements. Tr. pp. 16, 17 Since only JANE DOE and her daughter have operated the business from the time of her ownership ( Tr. p. 34), it is reasonable to conclude that either JANE DOE or her daughter made the bank deposits. Her daughter did not testify. Although JANE DOE testified, she was not questioned about the bank deposits. She was, however, questioned about the ROT returns that she prepared and filed, regarding which she testified that she accurately attempted to report taxpayer's sales using the sales receipts-a task she stated was not very hard. Tr. pp. 34, 37 Since these are the same returns that taxpayer now concedes do not truly reflect taxpayer's sales, JANE DOE's credibility in accurately conducting the financial aspect of taxpayer's business is doubtful, at best. Thus, I cannot conclude that the bank deposits, relied upon by the accountant to prepare taxpayer's federal and state income tax returns, and used by him to calculate taxpayer's mark-up, represent competent evidence, identified with taxpayer's books and records, entitled to the verity necessary to rebut the *prima facie* correctness of the Department's assessment.<sup>2</sup>

The same flaw lies in JIM DOE's reliance on the check register to establish the cost of goods. This reliance is premised on the fact that JANE DOE or her daughter paid for all goods with a check, rather than by cash. Taxpayer did not provide complete purchase invoices, therefore, I cannot accord ready credibility to the check register, an issue of major import in this matter. This is particularly true since, again, JANE DOE was not questioned regarding this area. Given the additional fact that I cannot conclude

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<sup>2</sup> Taxpayer Ex. No. 5, JOHN DOE'S Pasta Sales Tax Proposed Settlement'', offered through its preparer, JIM DOE, to summarize taxpayer's true tax liability, also suffers from the same lack of credibility, as it is

that JANE DOE conducted taxpayer's financial affairs in a reliable manner, I deduce that the check register relied upon by JIM DOE does not represent competent evidence entitled to the verity necessary to rebut the *prima facie* correctness of the Department's assessment.

Nor can taxpayer find support for its argument in Taxpayer Exs. No. 6 and 7. JIM DOE identified Exhibit No. 7 as a menu from the audit period. Tr. p. 27 Exhibit No. 6 consists of several parts. The first two pages are a spreadsheet, prepared by JIM DOE, showing: 1) the cost to prepare certain menu items, 2) the sales price of each item during the audit period, 3) the gross profit on each item and, 4) the gross profit percentage.<sup>3</sup> Tr. pp. 23-24

To sustain its representations regarding the cost to produce the various menu items, taxpayer appends as part of Exhibit No. 6, a breakdown of costs for thirty-five (35) menu items. For example, in its first illustration, Chicken/Pasta, taxpayer calculates the cost<sup>4</sup> of the chicken breast, spices, spaghetti, sauce, foil pan, lid, romano cheese, cheese cup/lid, bread sticks, bread sticks bag, butter/garlic, bag, napkins, and utensils necessary for its sale of the item. It supports its cost determinations with invoices highlighted for each particular specified, with these invoices showing these items as purchased in bulk. For example, taxpayer purchased parsley flakes in a 1 pound pail for \$7.50 and purchased 1 pound of crushed oregano for \$4.25, pursuant to the attached invoice dated 6/3/98. From this, taxpayer avers that it used \$.15 worth of spices in this particular dish. Tr. pp. 24-27 Taxpayer does the same for the other thirty-four items that comprise the remainder of this exhibit.

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based upon taxpayer's sales as determined from the monthly bank deposits. Tr. pp. 20-21

<sup>3</sup> JIM DOE calculated the gross profit percentage by dividing the gross profit by the sales price. Tr. p. 24

For the following reasons, this exhibit does not rebut the *prima facie* correctness of the NTL and the NOD at issue. First, the exhibit was introduced through JIM DOE, taxpayer's accountant. There is no indication that he has any competency as to how the various menu items were prepared. Although he testified, that "[w]e have calculated the actual cost to prepare these menu items..." (Tr. p. 24), there is no testimony as to who the "we" are. Nor was taxpayer's only other witness, JANE DOE, who actually operated the business, questioned about this exhibit. Additionally, the invoices appended to support the various costs are all subsequent to the tax periods at issue, although they are used to provide evidence of the costs of the menu items for the tax periods. Tr. pp. 24, 26-27

Taxpayer Exhibit No. 6 is further flawed in the fact that it does not represent taxpayer's costs for all products it sold during the tax periods. Pursuant to its menu (Taxpayer Exhibit No. 7), taxpayer sold a variety of salads, desserts and "beverages" not represented in its Exhibit No. 6 - *i.e.* olive salad, waldorf salad, mushroom and shrimp salads, cannolli, tortoni, ice cream, brownies, cheesecake, Italian ices and bottled soft drinks in various sizes. Taxpayer Exhibit No. 7; Taxpayer Exhibit No. 10 (photograph of store interior wherein various items are displayed) Since there are numerous foods sold by taxpayer during the tax periods that are not represented, in any respect, in Exhibit No. 6, any relevant mathematical analysis using cost of goods and sales, *etc.* derived from this exhibit fails. Taxpayer Exhibit No. 6 is simply neither a complete nor a credible representation of its costs of goods or its sales for the tax periods. See Quincy Trading Post Inc. v. Department of Revenue, 12 Ill. App.3d 725 (4<sup>th</sup> Dist. 1973) (taxpayer's incomplete documentary evidence and incredible oral testimony not sufficient to rebut the *prima facie* correctness of Department's assessment.)

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<sup>4</sup> Taxpayer calculates the cost for 1, 2, 4-6 and 6-8 servings of most of the menu items.



This is critical because while the taxpayer concedes that it owes the Department additional monies for its ROT obligation (averring that it only owes the equivalent of 2.2 times its cost of goods, as calculated by dividing its total sales as indicated by its bank deposits, by its cost of goods determined by its check register), it does not support this position with any competent, credible evidence as discussed above. However, even assuming its analysis in Exhibit 6 rises the level of competent evidence, identified with its books and records and “supported by proof of facts entitling it to be admitted as evidence or facts from some other source importing equal verity” (DuPage Liquor Store v. McKibbin, 383 Ill. 276, 279 (1943); Copilevitz v. Department of Revenue, 41 Ill.2d 154 (1968)), the exhibit actually supports a mark-up of 1.6 times the cost of goods, *i.e.* sales price totaling \$869.85 divided by cost of goods of \$557.97, and not the 2.2 mark-up shown on its federal and state income tax returns. This lack of consistency in taxpayer’s own documentation further enhances my determination that taxpayer’s books and records are not credible.

At a minimum, these flaws result from the fact that Taxpayer’s Exhibit 6 was prepared in anticipation of litigation, and without benefit of original, pertinent source documents. Tr. p. 31; In re A.B., S.B., J.B. and T.B., Minors, 308 Ill. App.3d 227, 236 (2<sup>nd</sup> Dist. 1999) (“Records prepared in anticipation of litigation are not records made in the regular course of business and thus are not admissible into evidence unless they fall within another exception to the hearsay rule. (citation omitted) A record is prepared in anticipation of litigation if it is prepared with an eye toward pending or anticipated litigation of any kind. (citation omitted.)”) Although the Department did not object to the admission of this exhibit, the law provides that it may be considered and given its natural

probative effect. Jackson v. Board of Review of Department of Labor, 105 Ill.2d 501, 508 (1985); S.W. v. Department of Children and Family Services, 276 Ill. app.3d 672, 682 (1<sup>st</sup> Dist. 1995) Because the exhibit is so seriously flawed, I cannot find that it is credible, and, therefore, I cannot afford it any weight in a determination of whether the taxpayer rebutted the *prima facie* correctness of the Department's proposed assessments.

In sum, taxpayer attempts to rebut the *prima facie* correctness of the Department's proposed assessments with, essentially, the following evidence: 1) a redaction of its cost of goods and total sales as reported on its federal tax returns for the tax periods, that results in a mark-up of 2.2 times the cost of goods; and 2) a documentary analysis, prepared in anticipation of litigation, of the cost of goods and sales based upon its menu for the tax periods, resulting in a mark-up of 1.6 times the cost of goods. All of this is intended to dispute the auditor's determination of a mark-up of 3 times the cost of goods and basing her assessment of underreported receipts on that determination.

Taxpayer did not present original documents at hearing, as it concedes that it did not keep books and records as mandated by statute and Department regulation. 35 ILCS 120/7; 86 Ill. Admin. Code, ch. I, sec. 130.805<sup>5</sup> In addition, the redaction of its cost of goods and total sales as reported on its federal tax returns was not credible as it rests on the reliability of the bank deposits made by JANE DOE, as well as on the presumption that all goods purchased were documented by check. Nor was taxpayer's analysis of its

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<sup>5</sup> Section 130.805 reads, in pertinent part:

- a) In General. Where a taxpayer's business consists exclusively of the sale of tangible personal property at retail, the following records will be deemed by the Department to constitute a minimum for the purposes of the Act [ROTA]:
  - 1) Cash register tapes and other data which will provide a daily record of the gross amount of sales.
  - 2) A record of the amount of merchandise purchased. To fulfill this requirement, copies of all vendors' invoices and taxpayers' copies of purchase orders must be retained serially and in sequence to date.

costs, *etc.*, based upon its menu for the tax period, credible for the reasons previously discussed. All of the above flaws require me to conclude that taxpayer failed to rebut the *prima facie* correctness of the Department's assessments reflected in the NTL and the NOD at issue.

**WHEREFORE**, for the above stated reasons, it is my recommendation that Notice of Tax Liability SF XXXXX and Notice of Deficiency for the tax years ending 12/31/95 and 12/31/96 be affirmed, in their entireties.

7/12/00

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Mimi Brin  
Administrative Law Judge

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3) A true and complete inventory of the value of stock on hand taken at least once each year.